surplus up to 25% of the sum of paragraphs (a) and (c)(1) of this section.

(Approved by the Office of Management and Budget under control number 1557–0166)

[50 FR 10216, Mar. 14, 1985, as amended at 55 FR 38801, Sept. 21, 1990; 60 FR 39229, Aug. 1, 1995; 61 FR 60363, Nov. 27, 1996; 63 FR 42674, Aug. 10, 1998]

APPENDIX A TO PART 3—RISK-BASED CAPITAL GUIDELINES

Section 1. Purpose, Applicability of Guidelines, and Definitions.

(a) *Purpose.* (1) An important function of the Office of the Comptroller of the Currency (*OCC*) is to evaluate the adequacy of capital maintained by each national bank. Such an evaluation involves the consideration of numerous factors, including the riskiness of a bank's assets and off-balance sheet items. This appendix A implements the OCC's risk-based capital guidelines. The risk-based capital ratio derived from those guidelines is more systematically sensitive to the credit risk associated with various bank activities than is a capital ratio based strictly on a bank's total balance sheet assets. A bank's risk-based capital ratio is obtained by dividing its capital base (as defined in section 2 of this appendix A) by its risk-weighted assets (as calculated pursuant to section 3 of this appendix A). These guidelines were created within the framework established by the report issued by the Committee on Banking Regulations and Supervisory Practices in July 1988. The OCC believes that the risk-based capital ratio is a useful tool in evaluating the capital adequacy of all national banks, not just those that are active in the international banking system.

(2) The purpose of this appendix A is to explain precisely (i) how a national bank's risk-based capital ratio is determined and (ii) how these risk-based capital guidelines are applied to national banks. The OCC will review these guidelines periodically for possible adjustments commensurate with its experience with the risk-based capital ratio and with changes in the economy, financial markets and domestic and international banking practices.

(b) *Applicability.* (1) The risk-based capital ratio derived from these guidelines is an important factor in the OCC's evaluation of a bank's capital adequacy. However, since this measure addresses only credit risk, the 8% minimum ratio should not be viewed as the level to be targeted, but rather as a floor. The final supervisory judgment on a bank's capital adequacy is based on an individualized assessment of numerous factors, including those listed in 12 CFR 3.10. With respect to the consideration of these factors, the OCC will give particular attention to any bank with significant exposure to declines in the economic value of its capital due to changes in interest rates. As a result, it may differ from the conclusion drawn from an isolated comparison of a bank's risk-based capital ration to the 8% minimum specified in these guidelines. In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

(2) Effective December 31, 1990, these risk-based capital guidelines will apply to all national banks. In the interim, banks must maintain minimum capital-to-total assets ratios as required by 12 CFR part 3, and should begin preparing for the implementation of these risk-based capital guidelines. In this regard, each national bank that does not currently meet the final minimum ratio established in section 4(b)(1) of this appendix A should begin planning for achieving that standard.

(3) These risk-based capital guidelines will not be applied to federal branches and agencies of foreign banks.

(c) *Definitions.* For purposes of this appendix A, the following definitions apply:

(1) *Allowances for loan and lease losses* means the balance of the valuation reserve on December 31, 1968, plus additions to the reserve charged to operations since that date, less losses charged against the allowance net of recoveries.

(2) *Associated company* means any corporation, partnership, business trust, joint venture, association or similar organization in which a national bank directly or indirectly holds a 20 to 50 percent ownership interest.

(3) *Banking and finance subsidiary* means any subsidiary of a national bank that engages in banking- and finance-related activities.

(4) *Cash items in the process of collection* means checks or drafts in the process of collection that are drawn on another depository institution, including a central bank, and that are payable immediately upon presentation in the country in which the reporting bank's office that is clearing or collecting the check or draft is located; U.S. Government checks that are drawn on the United States Treasury or any other U.S. Government or Government-sponsored agency and that are payable immediately upon presentation; broker's security drafts and commodity or bill-of-lading drafts payable immediately upon presentation in the United States or the country in which the reporting bank's office that is handling the drafts is located; and unposted debits.

(5) *Central government* means the national governing authority of a country; it includes the departments, ministries and agencies of the central government and the central bank. The U.S. Central Bank includes the 12

Federal Reserve Banks. The definition of central government does not include the following: State, provincial, or local governments; commercial enterprises owned by the central government, which are entities engaged in activities involving trade, commerce, or profit that are generally conducted or performed in the private sector of the United States economy; and non-central government entities whose obligations are guaranteed by the central government.

(6) *Commitment* means any arrangement that obligates a national bank to: (i) Purchase loans or securities; or (ii) extend credit in the form of loans or leases, participations in loans or leases, overdraft facilities, revolving credit facilities, or similar transactions.

(7) *Common stockholders' equity* means common stock, common stock surplus, undivided profits, capital reserves, and adjustments for the cumulative effect of foreign currency translation, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values.

(8) *Conditional guarantee* means a contingent obligation of the United States Government or its agencies, or the central government of an OECD country, the validity of which to the beneficiary is dependent upon some affirmative action—*e.g.,* servicing requirements—on the part of the beneficiary of the guarantee or a third party.

(9) *Deferred tax assets* means the tax consequences attributable to tax carryforwards and deductible temporary differences. Tax carryforwards are deductions or credits that cannot be used for tax purposes during the current period, but can be carried forward to reduce taxable income or taxes payable in a future period or periods. Temporary differences are financial events or transactions that are recognized in one period for financial statement purposes, but are recognized in another period or periods for income tax purposes. Deductible temporary differences are temporary differences that result in a reduction of taxable income in a future period or periods.

(10) *Derivative contract* means generally a financial contract whose value is derived from the values of one or more underlying assets, reference rates or indexes of asset values. Derivative contracts include interest rate, foreign exchange rate, equity, precious metals and commodity contracts, or any other instrument that poses similar credit risks.

(11) *Depository institution* means a financial institution that engages in the business of banking; that is recognized as a bank by the bank supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. In the U.S., this definition encompasses all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions, and international banking facilities of domestic depository institution. Bank holding companies are excluded from this definition. For the purposes of assigning risk weights, the differentiation between OECD depository institutions and non-OECD depository institutions is based on the country of incorporation. Claims on branches and agencies of foreign banks located in the United States are to be categorized on the basis of the parent bank's country of incorporation.

(12) *Exchange rate contracts* include: Cross-currency interest rate swaps; forward foreign exchange rate contracts; currency options purchased; and any similar instrument that, in the opinion of the OCC, gives rise to similar risks.

(13) *Goodwill* means an intangible asset that represents the excess of the purchase price over the fair market value of tangible and identifiable intangible assets acquired in purchases accounted for under the purchase method of accounting.

(14) *Intangible assets* include mortgage and non-mortgage servicing assets (but exclude any interest only (IO) strips receivable related to these mortgage and nonmortgage servicing assets), purchased credit card relationships, goodwill, favorable leaseholds, and core deposit value.

(15) *Interest rate contracts* include: Single currency interest rate swaps; basis swaps; forward rate agreements; interest rate options purchased; forward forward deposits accepted; and any similar instrument that, in the opinion of the OCC, gives rise to similar risks, including when-issued securities.

(16) *Multifamily residential property* means any residential property consisting of five or more dwelling units including apartment buildings, condominiums, cooperatives, and other similar structures primarily for residential use, but not including hospitals, nursing homes, or other similar facilities.

(17) The *OECD-based group of countries* comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow,[1] but

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[1] As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the

Continued

excludes any country that has rescheduled its external sovereign debt within the previous five years. These countries are hereinafter referred to as *OECD countries.* A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

(18) *Original maturity* means, with respect to a commitment, the earliest possible date after a commitment is made on which the commitment is scheduled to expire (*i.e.,* it will reach its stated maturity and cease to be binding on either party), *provided that* either:

(i) The commitment is not subject to extension or renewal and will actually expire on its stated expiration date; or

(ii) If the commitment is subject to extension or renewal beyond its stated expiration date, the stated expiration date will be deemed the original maturity only if the extension or renewal must be based upon terms and conditions independently negotiated in good faith with the customer at the time of the extension or renewal and upon a new, *bona fide* credit analysis utilizing current information on financial condition and trends.

(19) *Preferred stock* includes the following instruments: (i) *Convertible preferred stock,* which means preferred stock that is mandatorily convertible into either common or perpetual preferred stock; (ii) *Intermediate-term preferred stock,* which means preferred stock with an original maturity of at least five years, but less than 20 years; (iii) *Long-term preferred stock,* which means preferred stock with an original maturity of 20 years or more; and (iv) *Perpetual preferred stock,* which means preferred stock without a fixed maturity date that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. For purposes of these instruments, preferred stock that can be redeemed at the option of the holder is deemed to have an *original maturity* of the earliest possible date on which it may be so redeemed.

(20) *Public-sector entities* include states, local authorities and governmental subdivisions below the central government level in an OECD country. In the United States, this definition encompasses a state, county, city, town, or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a state or municipal corporation. This definition does not include commercial companies owned by the public sector.[1a]

(21) *Reciprocal holdings of bank capital instruments* means cross-holdings or other formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. This definition does not include holdings of capital instruments issued by other banking organizations that were taken in satisfaction of debts previously contracted, provided that the reporting national bank has not held such instruments for more than five years or a longer period approved by the OCC.

(22) *Replacement cost* means, with respect to interest rate and exchange rate contracts, the loss that would be incurred in the event of a counterparty default, as measured by the net cost of replacing the contract at the current market value. If default would result in a theoretical profit, the replacement value is considered to be zero. The mark-to-market process should incorporate changes in both interest rates and counterparty credit quality.

(23) *Residential properties* means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence.

(24) *Risk-weighted assets* means the sum of total risk-weighted balance sheet assets and the total of risk-weighted off-balance sheet credit equivalent amounts. Risk-weighted balance sheet and off-balance sheet assets are calculated in accordance with section 3 of this appendix A.

(25) *State* means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

(26) *Subsidiary* means any corporation, partnership, business trust, joint venture, association or similar organization in which a national bank directly or indirectly holds more than a 50% ownership interest. This definition does not include ownership interests that were taken in satisfaction of debts previously contracted, provided that the reporting bank has not held the interest for more than five years or a longer period approved by the OCC.

(27) *Total capital* means the sum of a national bank's core (Tier 1) and qualifying supplementary (Tier 2) capital elements.

United Kingdom, and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow.

[1a] *See* Definition (5), *Central government,* for further explanation of commercial companies owned by the public sector.

(28) *Unconditionally cancelable* means, with respect to a commitment-type lending arrangement, that the bank may, at any time, with or without cause, refuse to advance funds or extend credit under the facility. In the case of home equity lines of credit, the bank is deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the line, and terminate the commitment to the full extent permitted by relevant Federal law.

(29) *United States Government or its agencies* means an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

(30) *United States Government-sponsored agency* means an agency originally established or chartered to serve public purposes specified by the United States Congress, but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

(31) *Walkaway clause* means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

Section 2. Components of Capital.

A national bank's qualifying capital base consists of two types of capital—core (Tier 1) and supplementary (Tier 2).

(a) *Tier 1 Capital.* The following elements comprise a national bank's Tier 1 capital:

(1) Common stockholders' equity;

(2) Noncumulative perpetual preferred stock and related surplus; and [2]

(3) Minority interests in the equity accounts of consolidated subsidiaries.

(b) *Tier 2 Capital.* The following elements comprise a national bank's Tier 2 capital:

(1) Allowance for loan and lease losses, up to a maximum of 1.25% of risk-weighted assets,[3] subject to the transition rules in section 4(a)(2) of this appendix A;

(2) Cumulative perpetual preferred stock, long-term preferred stock, convertible preferred stock, and any related surplus, without limit, if the issuing national bank has the option to defer payment of dividends on these instruments. For long-term preferred stock, the amount that is eligible to be included as Tier 2 capital is reduced by 20% of the original amount of the instrument (net of redemptions) at the beginning of each of the last five years of the life of the instrument;

(3) Hybrid capital instruments, without limit. Hybrid capital instruments are those instruments that combine certain characteristics of debt and equity, such as perpetual debt. To be included as Tier 2 capital, these instruments must meet the following criteria:[4]

(i) The instrument must be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up;

(ii) The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the OCC;

(iii) The instrument must be available to participate in losses while the issuer is operating as a going concern (in this regard, the instrument must automatically convert to common stock or perpetual preferred stock, if the sum of the retained earnings and capital surplus accounts of the issuer shows a negative balance); and

(iv) The instrument must provide the option for the issuer to defer principal and interest payments, if

(A) The issuer does not report a net profit for the most recent combined four quarters, and

(B) The issuer eliminates cash dividends on its common and preferred stock.

(4) Term subordinated debt instruments, and intermediate-term preferred stock and related surplus are included in Tier 2 capital,

[2] Preferred stock issues where the dividend is reset periodically based upon current market conditions and the bank's current credit rating, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

[3] The amount of the allowance for loan and lease losses that may be included in capital is based on a percentage of risk-weighted assets. The gross sum of risk-weighted assets used in this calculation includes all risk-weighted assets, with the exception of the assets required to be deducted under section 3 in establishing risk-weighted assets (*i.e.*, the assets required to be deducted from capital under section 2(c)) of this appendix. A banking organization may deduct reserves for loan and lease losses in excess of the amount permitted to be included as capital, as well as allocated transfer risk reserves and reserves held against other real estate owned, from the gross sum of risk-weighted assets in computing the denominator of the risk-based capital ratio.

[4] Mandatory convertible debt instruments that meet the requirements of 12 CFR 3.100(e)(5), or that have been previously approved as capital by the OCC, are treated as qualifying hybrid capital instruments.

but only to a maximum of 50% of Tier 1 capital as calculated after deductions pursuant to section 2(c) of this appendix. To be considered capital, term subordinated debt instruments shall meet the requirements of §3.100(f)(1). However, pursuant to 12 CFR 5.47, the OCC may, in some cases, require that the subordinated debt be approved by the OCC before the subordinated debt may qualify as Tier 2 capital or may require prior approval for any prepayment (including payment pursuant to an acceleration clause or redemption prior to maturity) of the subordinated debt. Also, at the beginning of each of the last five years for the life of either type of instrument, the amount that is eligible to be included as Tier 2 capital is reduced by 20% of the original amount of that instrument (net of redemptions).

(5) Up to 45 percent of the pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values.[5] Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in Tier 2 capital, but the OCC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

(c) *Deductions from Capital.* The following items are deducted from the appropriate portion of a national bank's capital base when calculating its risk-based capital ratio:

(1) *Deductions from Tier 1 Capital.* The following items are deducted from Tier 1 capital before the Tier 2 portion of the calculation is made:

(i) Goodwill;

(ii) Other intangible assets, except as provided in section 2(c)(2) of this appendix A; and

(iii) Deferred tax assets, except as provided in section 2(c)(3) of this appendix A, that are dependent upon future taxable income, which exceed the lesser of either:

(A) The amount of deferred tax assets that the bank could reasonably expect to realize within one year of the quarter-end Call Report, based on its estimate of future taxable income for that year; or

(B) 10% of Tier 1 capital, net of goodwill and all intangible assets other than mortgage servicing assets, non-mortgage servicing assets, and purchased credit card relationships, and before any disallowed deferred tax assets are deducted.

(2) *Qualifying intangible assets.* Subject to the following conditions, mortgage servicing assets, nonmortgage servicing assets[6] and purchased credit card relationships need not be deducted from Tier 1 capital:

(i) The total of all intangible assets that are included in Tier 1 capital is limited to 100 percent of Tier 1 capital, of which no more than 25 percent of Tier 1 capital can consist of purchased credit card relationships and non-mortgage servicing assets in the aggregate. Calculation of these limitations must be based on Tier 1 capital net of goodwill and all identifiable intangible assets, other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships.

(ii) Banks must value each intangible asset included in Tier 1 capital at least quarterly at the lesser of:

(A) 90 percent of the fair value of each intangible asset, determined in accordance with section 2(c)(2)(iii) of this appendix A; or

(B) 100 percent of the remaining unamortized book value.

(iii) The quarterly determination of the current fair value of the intangible asset must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(iv) Banks may elect to deduct disallowed servicing assets on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

(3) *Deferred tax assets*—(i) Net unrealized gains and losses on available-for-sale securities. Before calculating the amount of deferred tax assets subject to the limit in section 2(c)(1)(iii) of this appendix A, a bank may eliminate the deferred tax effects of any net unrealized holding gains and losses on available-for-sale debt securities. Banks report these net unrealized holding gains and losses in their Call Reports as a separate component of equity capital, but exclude them from the definition of common stockholders' equity for regulatory capital purposes. A bank that adopts a policy to deduct these amounts must apply that approach consistently in all future calculations of the

[5] [Reserved]

[6] [Reserved]

[5] The OCC reserves the authority to exclude all or a portion of unrealized gains from Tier 2 capital if the OCC determines that the equity securities are not prudently valued.

[6] Intangible assets are defined to exclude any IO strips receivable related to these mortgage and non-mortgage servicing assets. See section 1(c)(14) of this appendix A. Consequently, IO strips receivable related to mortgage and non-mortgage servicing assets are not required to be deducted under section 2(c)(2) of this appendix A. However, these IO strips receivable are subject to a 100 percent risk weight under section 3(a)(4) of this appendix A.

amount of disallowed deferred tax assets under section 2(c)(1)(iii) of this appendix A.

(ii) *Consolidated groups.* The amount of deferred tax assets that a bank can realize from taxes paid in prior carryback years and from reversals of existing taxable temporary differences generally would not be deducted from capital. However, for a bank that is a member of a consolidated group (for tax purposes), the amount of carryback potential a bank may consider in calculating the limit on deferred tax assets under section 2(c)(1)(iii) of this appendix A, may not exceed the amount that the bank could reasonably expect to have refunded by its parent holding company.

(iii) *Nontaxable Purchase Business Combination.* In calculating the amount of net deferred tax assets under section 2(c)(1)(iii) of this appendix A, a deferred tax liability that is specifically associated with an intangible asset (other than purchased mortgage servicing rights and purchased credit card relationships) due to a nontaxable purchase business combination may be netted against that intangible asset. Only the net amount of the intangible asset must be deducted from Tier 1 capital. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of net deferred tax assets that are dependent upon future taxable income.

(iv) *Estimated future taxable income.* Estimated future taxable income does not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences expected to reverse within the year. A bank may use future taxable income projections for their closest fiscal year, provided it adjusts the projections for any significant changes that occur or that it expects to occur. Such projections must include the estimated effect of tax planning strategies that the bank expects to implement to realize net operating losses or tax credit carryforwards that will otherwise expire during the year.

(4) *Deductions from total capital.* The following items are deducted from total capital:

(i) Investments, both equity and debt, in unconsolidated banking and finance subsidiaries that are deemed to be capital of the subsidiary;[7] and

(ii) Reciprocal holdings of bank capital instruments.

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

The denominator of the risk-based capital ratio, *i.e.,* a national bank's risk-weighted assets,[8] is derived by assigning that bank's assets and off-balance sheet items to one of the four risk categories detailed in section 3(a) of this appendix A. Each category has a specific risk weight. Before an off-balance sheet item is assigned a risk weight, it is converted to an on-balance sheet credit equivalent amount in accordance with section 3(b) of this appendix A. The risk weight assigned to a particular asset or on-balance sheet credit equivalent amount determines the percentage of that asset/credit equivalent that is included in the denominator of the bank's risk-based capital ratio. Any asset deducted from a bank's capital in computing the numerator of the risk-based capital ratio is not included as part of the bank's risk-weighted assets.

Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets, *e.g.,* mutual funds, that encompasses more than one risk weight within the pool. In those situations, the bank may assign the asset to the risk category applicable to the highest risk-weighted asset that pool is permitted to hold pursuant to its stated investment objectives in the fund's prospectus. Alternatively, the bank may assign the asset on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In either case, the minimum risk weight that may be assigned to such a pool is 20%. If a bank assigns the asset on a pro rata basis, and the sum of the investment limits in the fund's prospectus exceeds 100%, the bank must assign the highest pro rata amounts of its total investment to the higher risk category. If, in order to maintain a necessary degree of liquidity, the fund is permitted to hold an insignificant amount of its assets in short-term, highly-liquid securities of superior credit quality (that do not qualify for a preferential risk weight), such securities generally will not be taken into account in determining the risk category into which the bank's holding in the overall pool should be assigned. The prudent use of hedging instruments by a fund to reduce the risk of its assets will not increase the risk weighting of the investment in that fund above the 20% category. However, if a fund engages in any activities that are deemed to be speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, the bank's investment in the fund will be assigned to the 100% risk category. More detail

[7] The OCC may require deduction of investments in other subsidiaries and associated companies, on a case-by-case basis.

[8] The OCC reserves the right to require a bank to compute its risk-based capital ratio on the basis of average, rather than period-end, risk-weighted assets when necessary to carry out the purposes of these guidelines.

on the treatment of mortgage-backed securities is provided in section 3(a)(3)(vi) of this appendix A.

(a) *On-Balance Sheet Assets.* The following are the risk categories/weights for on-balance sheet assets.

(1) *Zero percent risk weight.* (i) Cash, including domestic and foreign currency owned and held in all offices of a national bank or in transit. Any foreign currency held by a national bank should be converted into U.S. dollar equivalents.

(ii) Deposit reserves and other balances at Federal Reserve Banks.

(iii) Securities issued by, and other direct claims on, the United States Government or its agencies, or the central government of an OECD country.

(iv) That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country.[9]

(v) That portion of local currency claims on or unconditionally guaranteed by central governments of non-OECD countries, to the extent the bank has local currency liabilities in that country. Any amount of such claims that exceeds the amount of the bank's local currency liabilities is assigned to the 100% risk category of section 3(a)(4) of this appendix.

(vi) Gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is backed by gold bullion liabilities.

(vii) The book value of paid-in Federal Reserve Bank stock.

(viii) That portion of assets and off-balance sheet transactions[9a] collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country, provided that:[9b]

(A) The bank maintains control over the collateral:

(*1*) If the collateral consists of cash, the cash must be held on deposit by the bank or by a third-party for the account of the bank;

(*2*) If the collateral consists of OECD government securities, then the OECD government securities must be held by the bank or by a third-party acting on behalf of the bank;

(B) The bank maintains a daily positive margin of collateral fully taking into account any change in the market value of the collateral held as security;

(C) Where the bank is acting as a customer's agent in a transaction involving the loan or sale of securities that is collateralized by cash or OECD government securities delivered to the bank, any obligation by the bank to indemnify the customer is limited to no more than the difference between the market value of the securities lent and the market value of the collateral received, and any reinvestment risk associated with the collateral is borne by the customer; and

(D) The transaction involves no more than minimal risk.

(2) *20 percent risk weight.* (i) All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country. This includes the credit equivalent amount of participations in commitments and standby letters of credit sold to other depository institutions incorporated in an OECD country, but only if the originating bank remains liable to the customer or beneficiary for the full amount of the commitment or standby letter of credit. Also included in this category are the credit equivalent amounts of risk participations in bankers' acceptances conveyed to other depository institutions incorporated in an OECD country. However, bank-issued securities that qualify as capital of the issuing bank are not included in this risk category, but are assigned to the 100% risk category of section 3(a)(4) of this appendix A.

(ii) Claims on, or guaranteed by depository institutions, other than the central bank, incorporated in a non-OECD country, with a residual maturity of one year or less.

(iii) Cash items in the process of collection.

(iv) That portion of assets collateralized by cash or by securities issued or directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country,

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[9] For the treatment of privately-issued mortgage-backed securities where the underlying pool is comprised solely of mortgage-related securities issued by GNMA, *see infra* note 10.

[9a] See footnote 22 in section 3(b)(5)(iii) of this appendix A (collateral held against derivative contracts).

[9b] Assets and off-balance sheet transactions collateralized by securities issued or guaranteed by the United States Government or its agencies, or the central government of an OECD country include, but are not limited to, securities lending transactions, repurchase agreements, collateralized letters of credit, such as reinsurance letters of credit, and other similar financial guarantees. Swaps, forwards, futures, and options transactions are also eligible, if they meet the collateral requirements. However, the OCC may at its discretion require that certain collateralized transactions be risk weighted at 20 percent if they involve more than a minimal risk.

that does not qualify for the zero percent risk-weight category.

(v) That portion of assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country.

(vi) Securities issued by, or other direct claims on, United States Government-sponsored agencies.

(vii) That portion of assets guaranteed by United States Government-sponsored agencies.[10]

(viii) That portion of assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies.

(ix) Claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public-sector entity. In the U.S., these obligations must meet the requirements of 12 CFR 1.3(g).

(x) Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.[11]

(xi) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.

(xii) That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the bank has local currency liabilities in that country. Any amount of such claims that exceeds the amount of the bank's local currency liabilities is assigned to the 100% risk category of section 3(a)(4) of this appendix.

(3) *50 percent risk weight.* (i) Revenue obligations of any public-sector entity in an OECD country for which the underlying obligor is the public-sector entity, but which are repayable solely from the revenues generated by the project financed through the issuance of the obligations.

(ii) The credit equivalent amount of derivative contracts, calculated in accordance with section 3(b)(5) of this appendix A, that do not qualify for inclusion in a lower risk category.

(iii) Loans secured by first mortgages on one-to-four family residential properties, either owner-occupied or rented, provided that such loans are not otherwise 90 days or more past due, or on nonaccrual or restructured. It is presumed that such loans will meet prudent underwriting standards. If a bank holds a first lien and junior lien on a one-to-four family residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of both determining the loan-to-value ratio and assigning a risk weight to the transaction. Furthermore, residential property loans made for the purpose of construction financing are assigned to the 100% risk category of section 3(a)(4) of this appendix A; however, these loans may be included in the 50% risk category of this section 3(a)(3) of this appendix A if they are subject to a legally binding sales contract and satisfy the requirements of section 3(a)(3)(iv) of this appendix A.

(iv) Loans to residential real estate builders for one-to-four family residential property construction, if the bank obtains sufficient documentation demonstrating that the buyer of the home intends to purchase the home (*i.e.*, a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (*i.e.*, a firm written commitment for permanent financing of the home upon completion), subject to the following additional criteria:

(A) The builder must incur at least the first 10% of the direct costs (*i.e.*, actual costs of the land, labor, and material) before any drawdown is made under the construction

[10] Privately issued mortgage-backed securities, *e.g.*, CMOs and REMICs, where the underlying pool is comprised solely of mortgage-related securities issued by GNMA, FNMA and FHLMC, will be treated as an indirect holding of the underlying assets and assigned to the 20% risk category of this section 3(a)(2). If the underlying pool is comprised of assets which attract different risk weights, *e.g.*, FNMA securities and conventional mortgages, the bank should generally assign the security to the highest risk category appropriate for any asset in the pool. However, on a case-by-case basis, the OCC may allow the bank to assign the security proportionately to the various risk categories based on the proportion in which the risk categories are represented by the composition cash flows of the underlying pool of assets. Before the OCC will consider a request to proportionately risk-weight such a security, the bank must have current information for the reporting date that details the composition and cash flows of the underlying pool of assets. Furthermore, before a mortgage-related security will receive a risk weight lower than 100%, it must meet the criteria set forth in section 3(a)(3)(vi) of this appendix A.

[11] These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investments Bank, the International Monetary Fund and the Bank for International Settlements.

loan and the construction loan may not exceed 80% of the sales price of the resold home;

(B) The individual purchaser has made a substantial ''earnest money deposit'' of no less than 3% of the sales price of the home that must be subject to forfeiture by the individual purchaser if the sales contract is terminated by the individual purchaser; however, the earnest money deposit shall not be subject to forfeiture by reason of breach or termination of the sales contract on the part of the builder;

(C) The earnest money deposit must be held in escrow by the bank financing the builder or by an independent party in a fiduciary capacity; the escrow agreement must provide that in the event of default the escrow funds must be used to defray any cost incurred relating to any cancellation of the sales contract by the buyer;

(D) If the individual purchaser terminates the contract or if the loan fails to satisfy any other criterion under this section, then the bank must immediately recategorize the loan at a 100% risk weight and must accurately report the loan in the bank's next quarterly Consolidated Reports of Condition and Income (Call Report);

(E) The individual purchaser must intend that the home will be owner-occupied;

(F) The loan is made by the bank in accordance with prudent underwriting standards;

(G) The loan is not more than 90 days past due, or on nonaccrual; and

(H) The purchaser is an individual(s) and not a partnership, joint venture, trust, corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the homes for speculative purposes.

(v) Loans secured by a first mortgage on multifamily residential properties:[11a]

(A) The amortization of principal and interest occurs in not more than 30 years;

(B) The minimum original maturity for repayment of principal is not less than 7 years;

(C) All principal and interest payments have been made on a timely basis in accordance with the terms of the loan for at least one year immediately preceding the risk weighting of the loan in the 50% risk weight category, and the loan is not otherwise 90 days or more past due, or on nonaccrual status;

(D) The loan is made in accordance with all applicable requirements and prudent underwriting standards;

(E) If the rate of interest does not change over the term of the loan:

(I) The current loan amount outstanding does not exceed 80% of the current value of the property, as measured by either the value of the property at origination of the loan (which is the lower of the purchase price or the value as determined by the initial appraisal, or if appropriate, the initial evaluation) or the most current appraisal, or if appropriate, the most current evaluation; and

(II) In the most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120%;[11b]

(F) If the rate of interest changes over the term of the loan:

(I) The current loan amount outstanding does not exceed 75% of the current value of the property, as measured by either the value of the property at origination of the loan (which is the lower of the purchase price or the value as determined by the initial appraisal, or if appropriate, the initial evaluation) or the most current appraisal, or if appropriate, the most current evaluation; and

(II) In the most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 115%; and

(G) If the loan was refinanced by the borrower:

[11a] The portion of multifamily residential property loans that is sold subject to a *pro rata* loss sharing arrangement may be treated by the selling bank as sold to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a *pro rata* basis with the selling bank. The portion of multifamily residential property loans sold subject to any loss sharing arrangement other than *pro rata* sharing of the loss shall be accorded the same treatment as any other asset sold under an agreement to repurchase or sold with recourse under section 3(b)(1)(iii) (footnote 14) of this appendix A.

[11b] For the purposes of the debt service requirements in sections 3(a)(3)(v)(E)(II) and 3(a)(3)(v)(F)(II) of this appendix A, other forms of debt service coverage that generate sufficient cash flows to provide comparable protection to the institution may be considered for (a) a loan secured by cooperative housing or (b) a multifamily residential property loan if the purpose of the loan is for the development or purchase of multifamily residential property primarily intended to provide low- to moderate-income housing, including special operating reserve accounts or special operating subsidies provided by federal, state, local or private sources. However, the OCC reserves the right, on a case-by-case basis, to review the adequacy of any other forms of comparable debt service coverage relied on by the bank.

(I) All principal and interest payments on the loan being refinanced which were made in the preceding year prior to refinancing shall apply in determining the one-year timely payment requirement under paragraph (a)(3)(v)(C) of this section; and

(II) The net operating income generated by the property in the preceding year prior to refinancing shall apply in determining the applicable debt service requirements under paragraphs (a)(3)(v)(E) and (a)(3)(v)(F) of this section.

(vi) Privately-issued mortgage-backed securities, *i.e.* those that do not carry the guarantee of a government or government-sponsored agency, if the privately-issued mortgage-backed securities are at the time the mortgage-backed securities are originated fully secured by or otherwise represent a sufficiently secure interest in mortgages that qualify for the 50% risk weight under paragraphs (a)(3) (iii), (iv) and (v) of this section,[12] provided that they meet the following criteria:

(A) The underlying assets must be held by an independent trustee that has a first priority, perfected security interest in the underlying assets for the benefit of the holders of the security;

(B) The holder of the security must have an undivided pro rata ownership interest in the underlying assets or the trust that issues the security must have no liabilities unrelated to the issued securities;

(C) The trust that issues the security must be structured such that the cash flows from the underlying assets fully meet the cash flows requirements of the security without undue reliance on any reinvestment income; and

(D) There must not be any material reinvestment risk associated with any funds awaiting distribution to the holder of the security.

(4) *100 percent risk weight.* All other assets not specified above, including, but not limited to:

(i) Claims on or guaranteed by depository institutions incorporated in a non-OECD country, as well as claims on the central bank of a non-OECD country, with a residual maturity exceeding one year.

(ii) All non-local currency claims on non-OECD central governments, as well as local currency claims on non-OECD central governments that are not included in section 3(a)(1)(v) of this appendix A.

(iii) Any classes of a mortgage-backed security that can absorb more than their pro rata share of the principal loss without the whole issue being in default, *e.g.,* subordinated classes or residual interests, regardless of the issuer or guarantor.

(iv) All stripped mortgage-backed securities, including interest only portions (IOs), principal only portions (POs) and other similar instruments, regardless of the issuer or guarantor.

(v) Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligation, *e.g.,* industrial development bonds.

(vi) Claims on commercial enterprises owned by non-OECD and OECD central governments.

(vii) Any investment in an unconsolidated subsidiary that is not required to be deducted from total capital pursuant to section 2(c)(3) of this appendix A.

(viii) Instruments issued by depository institutions incorporated in OECD and non-OECD countries that qualify as capital of the issuer.

(ix) Investments in fixed assets, premises, and other real estate owned.

(b) *Off-Balance Sheet Activities.* The risk weight assigned to an off-balance sheet item is determined by a two-step process. First, the face amount of the off-balance sheet item is multiplied by the appropriate credit conversion factor specified in this section. This calculation translates the face amount of an off-balance sheet item into an on-balance sheet credit equivalent amount. Second, the resulting credit equivalent amount is then assigned to the proper risk category using the criteria regarding obligors, guarantors, and collateral listed in section 3(a) of this appendix A. Collateral and guarantees are applied to the face amount of an off-balance sheet item; however, with respect to derivative contracts under section 3(b)(5) of this appendix A, collateral and guarantees are applied to the credit equivalent amounts of such derivative contracts. The following are the credit conversion factors and the off-balance sheet items to which they apply.

(1) *100 percent credit conversion factor.* (i) Direct credit substitutes, including financial guarantee-type standby letters of credit that

[12] If all of the underlying mortgages in the pool do not qualify for the 50% risk weight, the bank should generally assign the entire value of the security to the 100% risk category of section 3(a)(4) of this appendix A; however, on a case-by-case basis, the OCC may allow the bank to assign only the portion of the security which represents an interest in, and the cash flows of, nonqualifying mortgages to the 100% risk category, with the remainder being assigned a risk weight of 50%. Before the OCC will consider a request to risk weight a mortgage-backed security on a proportionate basis, the bank must have current information for the reporting date that details the composition and cash flows of the underlying pool of mortgages.

support financial claims on the account party.[13] The face amount of a direct credit substitute is netted against the amount of any participations sold in that item. The amount not sold is converted to an on-balance sheet credit equivalent and assigned to the proper risk category using the criteria regarding obligors, guarantors and collateral listed in section 3(a) of this appendix A. Participations are treated as follows:

(A) If the originating bank remains liable to the beneficiary for the full amount of the standby letter of credit, in the event the participant fails to perform under its participation agreement, the amount of participations sold are converted to an on-balance sheet credit equivalent using a credit conversion factor of 100%, with that amount then being assigned to the risk category appropriate for the purchaser of the participation.

(B) If the participations are such that each participant is responsible only for its pro rata share of the risk, and there is no recourse to the originating bank, the full amount of the participations sold is excluded from the originating bank's risk-weighted assets;

(ii) Risk participations purchased in bankers' acceptances and participations purchased in direct credit substitutes;

(iii) Assets sold under an agreement to repurchase and assets sold with recourse,[14] to the extent that these assets are not reported on a national bank's statement of condition (this includes loan strips sold without direct recourse, where the maturity of the participation is shorter than the maturity of the underlying loan); and

(iv) Contingent obligations with a certain draw down, *e.g.*, legally binding agreements to purchase assets as a specified future date.

(v) Indemnification of customers whose securities the bank has lent as agent. If the customer is not indemnified against loss by the bank, the transaction is excluded from the risk-based capital calculation.[15]

(2) *50 percent credit conversion factor.* (i) Transaction-related contingencies including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction.[16] To the

[13] For purposes of this section 3(b)(1)(i), a ''financial guarantee-type standby letter of credit'' is any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party, in the event that the account party fails to fulfill its obligation to the beneficiary. Performance-based standby letters of credit are defined differently in section 3(b)(2)(i), *infra* note 16.

[14] For risk-based capital purposes, the definition of the sale of assets with recourse, including one-to-four family residential mortgages, is generally the same as the definition contained in the Instructions for the Preparation of the Consolidated Reports of Condition and Income (the Call Report). Assets sold in transactions in which the bank retains risk in a manner constituting recourse under the Call Report instructions, but which are not reported on the bank's statement of condition, are included in section 3(b)(1)(iii), even though the Call Report allows such transfers to be reported as sales. However, mortgage loans sold in transactions in which the bank retains only an insignificant amount of risk and makes concurrent provision for that risk are not considered assets sold with recourse under section 3. In order to qualify for sales treatment, such transactions must meet three conditions: (1) The bank has not retained any significant risk of loss, either directly or indirectly; (2) The bank's maximum contractual exposure under the recourse provision (or through the retention of a subordinated interest in the mortgages) at the time of the transfer is equal to or less than the amount of probable loss that the bank has reasonably estimated that it will incur on the transferred mortgages; and (3) The bank must have created a liability account or other special reserve in an amount equal to its maximum exposure. The amount of this liability account or other special reserve may not be included in capital for the purpose of determining compliance with either the risk-based capital requirement or the leverage ratio; nor may it be included in the allowance for loan and lease losses.

[15] When a bank lends its own securities, the transaction is treated as a loan. When a bank lends its own securities or, acting as agent, agrees to indemnify a customer, the transaction is assigned to the risk weight appropriate to the obligor or collateral that is delivered to the lending or indemnifying institution or to an independent custodian acting on their behalf.

[16] For purposes of this section 3(b)(2)(i), a ''performance-based standby letter of credit'' is any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by the account party in the performance of a nonfinancial or commercial obligation. Participations in performance-based standby letters of credit are treated in accordance with the provisions of section 3(b)(1)(i)(A)&(B) of this appendix A. Financial guarantee-type standby letters of credit are defined in section 3(b)(1)(i), *supra* note 13.

extent permitted by law or regulation, performance-based standby letters of credit include such things as arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids;

(ii) Unused portion of commitments, including home equity lines of credit, with an original maturity exceeding one year;[17] and

(iii) Revolving underwriting facilities, note issuance facilities, and similar arrangements pursuant to which the bank's customer can issue short-term debt obligations in its own name, but for which the bank has a legally binding commitment to either:

(A) Purchase the obligations the customer is unable to sell by a stated date; or

(B) Advance funds to its customer, if the obligations cannot be sold.

(3) *20 percent credit conversion factor.* (i) Trade-related contingencies. These are short-term self-liquidating instruments used to finance the movement of goods and are collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

(4) *Zero percent credit conversion factor.* (i) Unused portion of commitments with an original maturing of one year or less;

(ii) Unused portion of commitments with an original maturity of greater than one year, if they are unconditionally cancelable[18] at any time at the option of the bank and the bank has the contractual right to make, and in fact does make, either—

(A) A separate credit decision based upon the borrower's current financial condition, before each drawing under the lending facility; or

(B) An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued; and

(iii) The unused portion of retail credit card lines or other related plans that are unconditionally cancelable by the bank in accordance with applicable law.

(5) *Derivative contracts*—(i) *Calculation of credit equivalent amounts.* The credit equivalent amount of a derivative contract equals the sum of the current credit exposure and the potential future credit exposure of the derivative contract. The calculation of credit equivalent amounts must be measured in U.S. dollars, regardless of the currency or currencies specified in the derivative contract.

(A) *Current credit exposure.* The current credit exposure for a single derivative contract is determined by the mark-to-market value of the derivative contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market is zero or negative, then the current credit exposure is zero. The current credit exposure for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract is determined as provided by section 3(b)(5)(ii)(A) of this appendix A.

(B) *Potential future credit exposure.* The potential future credit exposure for a single derivative contract, including a derivative contract with negative mark-to-market value, is calculated by multiplying the notional principal[19] of the derivative contract by one of the credit conversion factors in Table A—Conversion Factor Matrix of this appendix A, for the appropriate category.[20] The potential future credit exposure for gold contracts shall be calculated using the foreign exchange rate conversion factors. For any derivative contract that does not fall within one of the specified categories in Table A—Conversion Factor Matrix of this appendix A, the potential future credit exposure shall be calculated using the other commodity conversion factors. Subject to examiner review, banks should use the effective rather than the apparent or stated notional amount in calculating the potential future credit exposure. The potential future credit exposure for multiple derivatives contracts executed with a single counterparty and subject to a qualifying bilateral netting contract is determined as provided by section 3(b)(5)(ii)(A) of this appendix A.

[17] Participations in commitments are treated in accordance with the provisions of section 3(b)(1)(i)(A)&(B) of this appendix A. Until December 31, 1992, national banks will be permitted to use remaining maturity in determining the appropriate credit conversion factor for the unused portion of loan commitments.

[18] See section 1(c)(26) of appendix A to this part.

[19] For purposes of calculating either the potential future credit exposure under section 3(b)(5)(i)(B) of this appendix A or the gross potential future credit exposure under section 3(b)(5)(ii)(A)(2) of this appendix A for foreign exchange contracts and other similar contracts in which the notional principal is equivalent to the cash flows, total notional principal is the net receipts to each party falling due on each value date in each currency.

[20] No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating indices, so-called floating/floating or basis swaps; the credit equivalent amount is measured solely on the basis of the current credit exposure.

TABLE A—CONVERSION FACTOR MATRIX[1]

Remaining maturity[2]	Interest rate	Foreign exchange rate and gold	Equity[2]	Precious metals	Other commodity
One year or less	0.0	1.0	6.0	7.0	10.0
Over one to five years	0.5	5.0	8.0	7.0	12.0
Over five years	1.5	7.5	10.0	8.0	15.0

[1] For derivative contracts with multiple exchanges of principal, the conversion factors are multiplied by the number of remaining payments in the derivative contract.

[2] For derivative contracts that automatically reset to zero value following a payment, the remaining maturity equals the time until the next payment. However, interest rate contracts with remaining maturities of greater than one year shall be subject to a minimum conversion factor of 0.5 percent.

(ii) *Derivative contracts subject to a qualifying bilateral netting contract*—(A) *Netting calculation.* The credit equivalent amount for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract as provided by section (3)(b)(5)(ii)(B) of this appendix A is calculated by adding the net current credit exposure and the adjusted sum of the potential future credit exposure for all derivative contracts subject to the qualifying bilateral netting contract.

(*1*) *Net current credit exposure.* The net current credit exposure is the net sum of all positive and negative mark-to-market values of the individual derivative contracts subject to a qualifying bilateral netting contract. If the net sum of the mark-to-market value is positive, then the net current credit exposure equals that net sum of the mark-to-market value. If the net sum of the mark-to-market value is zero or negative, then the net current credit exposure is zero.

(*2*) *Adjusted sum of the potential future credit exposure.* The adjusted sum of the potential future credit exposure is calculated as:

$$A_{net}=0.4\times A_{gross}+(0.6\times NGR\times A_{gross})$$

A_{net} is the adjusted sum of the potential future credit exposure, A_{gross} is the gross potential future credit exposure, and NGR is the net to gross ratio. A_{gross} is the sum of the potential future credit exposure (as determined under section 3(b)(5)(i)(B) of this appendix A) for each individual derivative contract subject to the qualifying bilateral netting contract. The NGR is the ratio of the net current credit exposure to the gross current credit exposure. In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under section 3(b)(5)(i)(A) of this appendix A) of all individual derivative contracts subject to the qualifying bilateral netting contract.

(B) *Qualifying bilateral netting contract.* In determining the current credit exposure for multiple derivative contracts executed with a single counterparty, a bank may net derivative contracts subject to a qualifying bilateral netting contract by offsetting positive and negative mark-to-market values, provided that:

(*1*) The qualifying bilateral netting contract is in writing.

(*2*) The qualifying bilateral netting contract is not subject to a walkaway clause.

(*3*) The qualifying bilateral netting contract creates a single legal obligation for all individual derivative contracts covered by the qualifying bilateral netting contract. In effect, the qualifying bilateral netting contract must provide that the bank would have a single claim or obligation either to receive or to pay only the net amount of the sum of the positive and negative mark-to-market values on the individual derivative contracts covered by the qualifying bilateral netting contract. The single legal obligation for the net amount is operative in the event that a counterparty, or a counterparty to whom the qualifying bilateral netting contract has been assigned, fails to perform due to any of the following events: default, insolvency, bankruptcy, or other similar circumstances.

(*4*) The bank obtains a written and reasoned legal opinion(s) that represents, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy, or similar circumstances, the relevant court and administrative authorities would find the bank's exposure to be the net amount under:

(*i*) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(*ii*) The law of the jurisdiction that governs the individual derivative contracts covered by the bilateral netting contract; and

(*iii*) The law of the jurisdiction that governs the qualifying bilateral netting contract.

(*5*) The bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the qualifying bilateral netting contract continues to satisfy the requirement of this section.

(*6*) The bank maintains in its files documentation adequate to support the netting of a derivative contract.[21]

(iii) *Risk weighting.* Once the bank determines the credit equivalent amount for a derivative contract or a set of derivative contracts subject to a qualifying bilateral netting contract, the bank assigns that amount to the risk weight category appropriate to the counterparty, or, if relevant, the nature of any collateral or guarantee.[22] However, the maximum weight that will be applied to the credit equivalent amount of such derivative contract(s) is 50 percent.

(iv) *Exceptions.* The following derivative contracts are not subject to the above calculation, and therefore, are not part of the denominator of a national bank's risk-based capital ratio:

(A) An exchange rate contract with an original maturity of 14 calendar days or less;[23] and

(B) A derivative contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

(c) *Alternative Capital Calculation for Small Business Obligations.* (1) *Definitions.* For purposes of this section 3(c):

(i) *Qualified bank* means a bank that:

(A) Is well capitalized as defined in 12 CFR 6.4 without applying the capital treatment described in this section 3(c), or

(B) Is adequately capitalized as defined in 12 CFR 6.4 without applying the capital treatment described in this section 3(c) and has received written permission from the appropriate district office of the OCC to apply the capital treatment described in this section 3(c).

(ii) *Recourse* has the meaning given to such term under generally accepted accounting principles.

(iii) *Small business* means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

(2) *Capital and reserve requirements.* With respect to a transfer of a small business loan or a lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified bank may elect to apply the following treatment:

(i) The bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement;

(ii) For purposes of calculating the bank's risk-based capital ratio, the bank includes only the amount of its retained recourse in its risk-weighted assets; and

(iii) For purposes of calculating the bank's tier 1 leverage ratio, the bank excludes from its average total consolidated assets the outstanding principal amount of the small business loans and leases transferred with recourse.

(3) *Limit on aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases of personal property and included in the risk-weighted assets of the bank as described in section 3(c)(2) of this appendix A may not exceed 15 percent of the bank's total capital after adjustments and deductions, unless the OCC specifies a greater amount by order.

(4) *Bank that ceases to be qualified or that exceeds aggregate limit.* If a bank ceases to be a qualified bank or exceeds the aggregate limit in section 3(c)(3) of this appendix A, the bank may continue to apply the capital treatment described in section 3(c)(2) of this appendix A to transfers of small business loans and leases of personal property that occurred when the bank was qualified and did not exceed the limit.

(5) *Prompt Corrective Action not affected.* (i) A bank shall compute its capital without regard to this section 3(c) for purposes of prompt corrective action (12 U.S.C. 1831o and 12 CFR part 6) unless the bank is an adequately or well capitalized bank (without applying the capital treatment described in this section 3(c)) and, after applying the capital treatment described in this section 3(c), the bank would be well capitalized.

(ii) A bank shall compute its capital without regard to this section 3(c) for purposes of

[21] By netting individual derivative contracts for the purpose of calculating its credit equivalent amount, a bank represents that documentation adequate to support the netting of a set of derivative contract is in the bank's files and available for inspection by the OCC. Upon determination by the OCC that a bank's files are inadequate or that a qualifying bilateral netting contract may not be legally enforceable in any one of the bodies of law described in section 3(b)(5)(ii)(B)(*3*)(*i*) through (*iii*) of this appendix A, the underlying derivative contracts may not be netted for the purposes of this section.

[22] Derivative contracts are an exception to the general rule of applying collateral and guarantees to the face value of off-balance sheet items. The sufficiency of collateral and guarantees is determined on the basis of the credit equivalent amount of derivative contracts. However, collateral and guarantees held against a qualifying bilateral netting contract is not recognized for capital purposes unless it is legally available for all contracts included in the qualifying bilateral netting contract.

[23] Notwithstanding section 3(b)(5)(B) of this appendix A, gold contracts do not qualify for this exception.

12 U.S.C. 1831o(g) regardless of the bank's capital level.

(d) *Recourse Obligations.* Where the amount of recourse liability retained by a bank is less than the capital requirement for credit-risk exposure, the bank shall maintain capital for the recourse liability equal to the amount of credit-risk exposure retained. Any recourse liability that is subject to this section 3(c) is not subject to any additional capital treatment under sections 3(a) or 3(b) of this appendix A.

Section 4. Implementation, Transition Rules, and Target Ratios

(a) *December 31, 1990 to December 30, 1992.* During this time period:

(1) All national banks are expected to maintain a minimum ratio of total capital (after deductions) to risk-weighted assets of 7.25%.

(i) Fifty percent of this 7.25% must be made up of Tier 1 capital; however, up to 10% of Tier 1 capital can be comprised of Tier 2 capital elements, before any deductions for goodwill. The amount of Tier 2 elements included in Tier 1 will not be subject to the sublimits on the amount of such elements in Tier 2 capital, with the exception of the allowance for loan and lease losses.

(ii) Goodwill that national banks have been allowed to count as capital as a result of the transition rules contained in 12 CFR 3.3 is grandfathered until December 31, 1992, but will be deducted from Tier 1 capital after that date.

(2) The allowance for loan and lease losses can be included in total capital up to a maximum of 1.5% of a bank's risk-weighted assets, including the portion that can be borrowed to make up Tier 1.

(3) Tier 2 capital elements that are not used as part of Tier 1 capital will qualify as part of a national bank's total capital base up to a maximum of 100% of the bank's Tier 1 capital.

(4) In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

(b) *On December 31, 1992.* (1) All national banks are expected to maintain a minimum ratio of total capital (after deductions) to risk-weighted assets of 8.0%.

(2) Tier 2 capital elements qualify as part of a national bank's total capital base up to a maximum of 100% of that bank's Tier 1 capital.

(3) In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.

TABLE 1—SUMMARY OF RISK WEIGHTS AND RISK CATEGORIES

Category 1: Zero Percent

1. Cash (domestic and foreign).
2. Balances due from, and claims on, Federal Reserve Banks and central banks in other OECD countries.
3. Claims on, or unconditionally guaranteed by, the U.S. Government or its agencies, or other OECD central governments.[1]
4. That portion of local currency claims on or unconditionally guaranteed by non-OECD central governments to the extent the bank has local currency liabilities in that country.
5. Gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is backed by gold bullion liabilities.
6. Federal Reserve Bank stock.

Category 2: 20 Percent

1. Portions of loans and other assets collateralized by securities issued or guaranteed by the U.S. Government or its agencies, or other OECD central governments.[2]
2. Portions of loans and other assets conditionally guaranteed by the U.S. Government or its agencies, or other OECD central governments.
3. Portions of loans and other assets collateralized by cash on deposit in the lending institution.
4. All claims (long- and short-term) on, or guaranteed by, OECD depository institutions.
5. Claims on, or guaranteed by, non-OECD depository institutions with a residual maturity of one year or less.
6. Cash items in the process of collection.
7. Securities and other claims on, or guaranteed by, U.S. Government-sponsored agencies.[3]
8. Portions of loans and other assets collateralized by securities issued by, or

[1] For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

[2] Degree of collateralization is determined by current market value.

[3] For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

guaranteed by, U.S. Government-sponsored agencies.[4]

9. Claims that represent general obligations of, and portions of claims guaranteed by, public-sector entities in OECD countries, below the level of central government.

10. Claims on or guaranteed by official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.

11. Portions of loans and other assets collateralized with securities issued by official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.

12. That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the bank has local currency liabilities in that country.

Category 3: 50 Percent

1. Revenue bonds or similar obligations, including loans and leases, that are obligations of public sector entities in OECD countries, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed.

2. Credit equivalent amounts of interest rate and exchange rate related contracts, except for those assigned to a lower risk category.

3. Assets secured by a first mortgage on a one-to-four family residential property that are not more than 90 days past due, on nonaccrual or restructured.

4. Loans to residential real estate builders for one-to-four family residential property construction that have been presold pursuant to legally binding written sales contract.

5. Assets secured by a first mortgage on multifamily residential properties.

Category 4: 100 Percent

1. All other claims on private obligors.

2. Claims on non-OECD financial institutions with a residual maturity exceeding one year. Claims on non-OECD central banks with a residual maturity exceeding one year are included in this category unless they qualify for item 4 of Category 1.

3. Claims on non-OECD central governments that are not included in item 4 of Category 1.

4. Obligations issued by state or local governments (including industrial development authorities and similar entities) repayable solely by a private party or enterprise.

5. Premises, plant, and equipment; other fixed assets; and other real estate owned.

6. Investments in unconsolidated subsidiaries, joint ventures, or associated companies (unless deducted from capital).

7. Capital instruments issued by other banking organizations.

8. All other assets (including claims on commercial firms owned by the public sector).

TABLE 2—CREDIT CONVERSION FACTORS FOR OFF-BALANCE SHEET ITEMS

100 Percent Conversion Factor

1. Direct credit substitutes (general guarantees of indebtedness and guarantee-type instruments, including standby letters of credit serving as financial guarantees for, or supporting, loans and securities).

2. Risk participations in bankers acceptances and participations in direct credit substitutes (*e.g.*, standby letters of credit).

3. Sale and repurchase agreements and asset sales with recourse, if not already included on the balance sheet.

4. Forward agreements (*i.e.*, contractual obligations) to purchase assets, including financing facilities with *certain* drawdown.

50 Percent Conversion Factor

1. Transaction-related contingencies (*e.g.*, bid bonds, performance bonds, warranties, and standby letters of credit related to particular transactions).

2. Unused portion of commitments with an original maturity exceeding one year.

3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs) and other similar arrangements.

20 Percent Conversion Factor

1. Short-term, self-liquidating trade-related contingencies, including commercial letters of credit.

Zero Percent Conversion Factor

1. Unused portion of commitments with an original maturity of one year or less.

2. Unused portion of commitments which are unconditionally cancelable at any time, regardless of maturity.

TABLE 3—TREATMENT OF DERIVATIVE CONTRACTS

1. The current exposure method is used to calculate the credit equivalent amounts of derivative contracts. These amounts are assigned a risk weight appropriate to the obligor or any collateral or guarantee. However, the maximum risk weight is limited to 50 percent. Multiple derivative contracts with a single counterparty may be netted if those

[4] Degree of collateralization is determined by current market value.

contracts are subject to a qualifying bilateral netting contract.

CONVERSION FACTOR MATRIX [1]

[Percent]

Remaining maturity [2]	Interest rate	Foreign exchange rate and gold	Equity [2]	Precious metals	Other commodity
One year or less	0.0	1.0	6.0	7.0	10.0
Over one to five years	0.5	5.0	8.0	7.0	12.0
Over five years	1.5	7.5	10.0	8.0	15.0

[1] For derivative contracts with multiple exchanges of principal, the conversion factors are multiplied by the number of remaining payments in the derivative contract.

[2] For derivative contracts that automatically reset to zero value following a payment, the remaining maturity equals the time until the next payment. However, interest rate contracts with remaining maturities of greater than one year shall be subject to a minimum conversion factor of 0.5 percent.

2. The following derivative contracts will be excluded:

a. Exchange rate contract with an original maturity of 14 calendar days or less; and

b. Derivative contract traded on exchanges and subject to daily margin requirements.

TABLE 4—DEFINITION OF CAPITAL

Capital components are distributed between two categories (Tier 1 and Tier 2). Tier 2 capital elements will qualify as part of a bank's total capital base up to a maximum of 100% of that bank's Tier 1 capital. Beginning December 31, 1992, the minimum risk-based capital standard will be 8.0%.

Definition of Capital

Tier 1:

• Common stockholders' equity;
• Noncumulative perpetual preferred stock and any related surplus; and
• Minority interests in the equity accounts of consolidated subsidiaries.

Tier 2:

• Cumulative perpetual, long-term and convertible preferred stock, and any related surplus;[5]
• Perpetual debt and other hybrid debt/equity instruments;
• Intermediate-term preferred stock and term subordinated debt (to a maximum of 50% of Tier 1 capital); and
• Loan loss reserves (to a maximum of 1.25% of risk-weighted assets).

Deductions from Capital:

From Tier 1:

• Goodwill and other intangibles, with the exception of identified intangibles that satisfy the criteria included in the guidelines.

From Total Capital:

• Investments in unconsolidated banking and finance subsidiaries;
• Reciprocal holdings of capital instruments

Transitional Definition

During a transition period beginning December 31, 1990, all national banks are expected to maintain a capital to risk-weighted asset ratio of 7.25%, of which at least 3.25 percentage points must consist of Tier 1 capital. In other words, during this period upon to approximately 4 percentage points of the 7.25% capital ratio may consist of Tier 2 capital. Also during this period, the sublimit on loan loss reserves will be 1.5% of risk-weighted assets.Q04

[54 FR 4177, Jan. 27, 1989]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting Appendix A to part 3 of title 12, see the List of CFR Sections Affected in the Finding Aids section of this volume.

APPENDIX B TO PART 3—RISK-BASED CAPITAL GUIDELINES; MARKET RISK ADJUSTMENT

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) *Purpose.* The purpose of this appendix is to ensure that banks with significant exposure to market risk maintain adequate capital to support that exposure.[1] This appendix

[5] The amount of long-term and intermediate-term preferred stock, as well as term subordinated debt that is eligible to be included as Tier 2 capital is reduced by 20% of the original amount of the instrument at the beginning of each of the last five years of the life of the instrument.

[1] This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled ''Amendment to the Capital Accord to Incorporate Market Risk,'' January 1996.